Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1996

SNAP-DRAPE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

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78 pp

QUESTION PRESENTED

I. Is Treasury Regulation § 1.56(g)(4)(C)(i) invalid as a Legislative Regulation because it is an attempt by Treasury to subject companies having ESOPs, to the Corporate Alternative Minimum Tax without either Congressional mandate or compliance with the Administrative Procedure Act, and invalid as an Interpretative Regulation because it goes byond the statute?

LIST OF INTERESTED PARTIES

1. Snap-Drape, Inc., Petitioner

2. The Snap-Drape Employee Stock Ownership Plan (the "ESOP")

3. The employees and former employees of Snap-Drape, Inc. who are participants in the Snap-Drape ESOP

4. Commissioner of Internal Revenue, Respondent

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For The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

Opinions Below

The opinion of the Court of Appeals is reported at 98 F.3d 194 (1996) and is reproduced in the Appendix filed herewith ("App.") at A. The opinion of the Tax Court in this

case is reported at 105 T.C. 16 (1995) and is reproduced at App. B.

Statement of Jurisdiction

This is a Petition for Writ of Certiorari to review a Decision of the United States Court of Appeals for the Fifth Circuit which was entered on March 13, 1997. Petitioner's Petition for Rehearing was denied on January 13, 1997. Petitioner filed a typewritten Petition for Writ of Certiorari on April 14, 1997. The Court replied by letter dated April 21, 1997 granting 60 days or until June 20, 1997 to file a corrected Petition for Writ of Certiorari. Petitioner invokes the jurisdiction of the Court under 26 U.S.C. § 7482(a)(1) and 28 U.S.C. § 1254.

Statutes Involved

Internal Revenue Code of 1986

Sec. 55. ALTERNATIVE MINIMUM TAX IMPOSED.

(a) **GENERAL RULE.**—There is hereby imposed (in addition to any other tax imposed by this subtitle) a tax equal to the excess (if any) of—

(1) the tentative minimum tax for the taxable year, over

(2) the regular tax for the taxable year.

(b) **Tentative Minimum Tax.—For purposes of this part—**

(1) **In general.**—The tentative minimum tax for the taxable year is—

(A) 20 percent (21 percent in the case of a taxpayer other than a corporation) of so much of the alternative minimum taxable income for the taxable year as

exceeds the exemption amount, reduced by

(B) the alternative minimum tax foreign tax credit for the taxable year.

(2) **Alternative minimum taxable income.**—The term "alternative minimum taxable income" means the taxable income of the taxpayer for the taxable year—

* * *

(c) **REGULAR TAX.**—

(1) In general.—For purposes of this section, the term "regular tax" means the regular tax liability for the taxable year (as defined in section 26(b))

Sec. 56. ADJUSTMENTS IN COMPUTING ALTERNATIVE MINIMUM TAXABLE INCOME.

* * *

(c) **ADJUSTMENTS APPLICABLE TO CORPORATIONS.**—In determining the amount of the alternative minimum taxable income of a corporation, the following treatment shall apply:

(1) **ADJUSTMENT FOR ADJUSTED CURRENT EARNINGS.**—Alternative minimum taxable income shall be adjusted as provided in subsection (g).

* * *

(g) **ADJUSTMENTS BASED ON ADJUSTED CURRENT EARNINGS.**—

(1) **IN GENERAL.**—The alternative minimum taxable income of any corporation for any taxable year beginning after 1989 shall be increased by 75 percent of the excess (if any) of—

(A) the adjusted current earnings of the corporation, over

(B) the alternative minimum taxable income

* * *

(4) **ADJUSTMENTS.**— In determining adjusted current earnings, the following adjustments shall apply:

* * *

(C) Disallowance of items not deductible in computing earnings and profits.—

(i) In general.—A deduction shall not be allowed for any item if such item would not be deductible for any taxable year for purposes of computing earnings and profits.

. . .

(5) **OTHER DEFINITIONS.**—For purposes of paragraph (4)—

(A) **EARNINGS AND PROFITS.**—The term "earnings and profits" means earnings and profits computed for purposes of subchapter C.

OMNIBUS BUDGET RECONCILIATION ACT OF 1989,

Pub. L. No. 101-239, § 7611(g)(3), 103 Stat. 2106, 2373:

SEC. 7611. SIMPLIFICATION OF ADJUSTED CURRENT EARNINGS PREFERENCE. . . .

. . .

(g) **EFFECTIVE DATES.**— . . .

(3) **REGULATIONS ON EARNINGS AND PROFITS RULES.**—Not later than March 15, 1991, the Secretary of the Treasury or his delegate shall prescribe initial regulations providing guidance as to which items of income are included in adjusted current earnings under Section 56(g)(4)(B)(i) of the Internal Revenue Code of 1986 and which items of deduction are

disallowed under Section 56(g)(4)(C) of such Code.

Statement of the Case

In the early 1970s Ray Belknap and Jerry Guebert, two salesmen, called on a large hotel in Houston. They spent some time together in a ballroom watching hotel employees set the room up for a function later that day. On the head tables, and display tables, hotel employees would spread a tablecloth over the top of a table and then take additional tablecloths and fold them and pin them to the edges of the top tablecloth to form a "skirt" around the table. The job was slow and tedious and the employees kept sticking their fingers with the pins. They thought there must be a better way to do this and went back to their hotel and started working on a device to make the job easier. They came up with an idea to snap the skirting to the table. They took a piece of plastic, heated it with a cigarette lighter, and bent it to various shapes trying to figure out a way to attach snaps to the table. If snaps were sewn into the drapery material, and snaps could be clipped to the table, then drapery could be snapped to the table. This should make the job go faster, and it would be more pleasant for the workers. Belknap and Guebert returned to their homes in Dallas and had a plastic injection molding company make a prototype of their snap-on clips for table drapery. They took their ideas to a patent attorney and obtained a patent. They formed Snap-Drape, Inc. to manufacture and sell table skirting which would be attached to tables by snapping it on with their patented clips. The patent protected their business and they were able to establish a firm foothold in the hotel, restaurant and convention industries before their patents expired. Their business grew and prospered. By the time their patents had expired, "Snap-Drape" had become a generic term for table skirting much as "Kleenex"

is to tissues.

Jerry and Ray were the only two executives of the company and spent most of their time in sales. Snap-Drape had a small administrative staff. Most of Snap-Drape's employees were in manufacturing; they actually stitched together the table skirting and shipped the products to customers. By 1990 the company had about 70 or 80 employees and was grossing 6 or 7 million dollars a year. Many of the employees were legal immigrants. They had a better job with Snap-Drape than they could have ever dreamed of at home, and better than most jobs they could find in the United States. It was steady, well paying, safe and pleasant work. There were no high paid executives, and the company ran mean and lean. There was no retirement plan for the employees.

By 1989 Ray Belknap realized that he was really past retirement age and that his health was not very good. He owed it to his family to retire and spend some time with them. Jerry Guebert was a little younger than Ray and believed that he would be wise to go ahead and retire also. The problem with their retirement was that the only thing they really had of value was Snap-Drape. They owned its stock fifty-fifty. They wanted to sell Snap-Drape to fund their retirement, but there are not many buyers for small companies of this sort, particularly companies that do not have a middle layer of management that is capable of taking over and running the company. Anticipating this, Ray and Jerry brought in Felton Norris, who was experienced in the textile industry, as the heir apparent to take over as president of the company. They had previously explored various ways of selling the company but were unable to attract much interest. Norris wanted to buy it but could not get the financing on his own. Any buyer who was not familiar with the operations of the company or the market for its

products would have no way of knowing how to manage the company, or what it might be worth. A small company of this sort does not make good collateral for a loan and it was no large enough for a public stock offering.

Snap-Drape's accountant, Gary Hatfield, came up with a good idea. He was aware of a concept under the tax law known as an ESOP. An ESOP, or Employee Stock Ownership Plan, is a tax favored arrangement in the general family of Qualified Retirement Plans provided for in the Internal Revenue Code.[1] ESOPs are funded by Employer contributions based on a percent of employee compensation, and dividends on the employer stock owned by the plan. ESOPs are a form of deferred compensation for employees. The Internal Revenue Code allows a tax deduction both for Contributions to the plan and Dividends paid to the plan, if the dividends are used to repay an employer stock acquisition loan ("ESOP loan"). ESOP's were frequently used in leveraged buy-outs of small and large companies.

Belknap, Guebert, Norris and Hatfield discussed the ESOP concept and thought it might have merit. They approached a bank about making an ESOP loan. The bank appraised the company and decided that an ESOP arrangement would be feasible if the company could "pay for itself" with tax deductible dollars by using dividends deductible under Code § 404(k). The bank's appraisers determined that the company was worth about $6.25 million, but the bank was willing to loan only $5 million. A deal was struck whereby an ESOP was

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[1] All references to the Internal Revenue Code or "Code" are to the Internal Revenue Code of 1986, as amended, as applicable to the taxable year in question.

formed to buy 80% of the stock for $5 million. The purchase would be funded entirely by a loan from the bank. All of Snap-Drape's employees would participate in the ESOP, subject to normal ERISA participation and vesting rules.

On February 1, 1990 the ESOP was established. Nearly all the employees were eligible to participate and became shareholders. On February 22, 1990 the ESOP purchased the stock for $5 million. The ESOP borrowed the $5 million from the bank. The debt service to pay off a $5 million loan in a reasonable amount of time would require over $1,000,000 per year. The percentage limitations under § 415 of the Internal Revenue Code made the maximum tax deductible **contribution** that Snap-Drape could make to the ESOP about $240,000 per year. The difference would have to be paid out of **dividends** on the stock owned by the ESOP. Snap-Drape was profitable and could afford to pay enough dividends on its stock so that the ESOP could pay the loan, if the dividends were tax deductible. If the dividends would have to come out of "after-tax dollars" there would not be enough cash flow to pay the loan and pay the Tax, too. Snap-Drape guaranteed the ESOP loan, obligating itself to pay not only the maximum deductible **contribution** to the ESOP, but also sufficient **dividends** to the ESOP to enable it to service the debt. The combination of tax deductible contributions and tax deductible dividends would be enough to allow the ESOP to pay off the loan over 5 to 7 years.

The bank assigned a senior lending officer to the case who was familiar with Snap-Drape, and another senior lending officer who was an expert in the field of ESOP loans. The bank hired a law firm in Chicago noted for its expertise in ESOPs. Gerald Kaplin of that firm, a leading expert in the field, together with his partners and associates, drafted the loan agreements, approved the form of the ESOP document, approved the form

of the stock purchase agreement, and approved all the other documents incident to the acquisition of Belknap and Guebert's stock by the ESOP. All the parties to the transaction were well advised and their advisors knew that the loan could not be repaid with deductible contributions alone. The company would have to be profitable and pay nearly all of its profits to the ESOP so the ESOP could pay the debt. Cash flow projections indicated the company and the ESOP could do it if the dividends were tax deductible. All of the advisors were aware that the dividends were specifically made deductible by Code § 404(k). All the parties relied on the fact that these dividends would be fully tax deductible in determining the amount of cash flow available to pay the ESOP loan. Snap-Drape, its advisors, the bank and its advisors all specifically considered whether the minimum tax might apply. They all assumed that the dividends used to pay off the ESOP loan would be deductible for regular tax purposes and also for minimum tax purposes. The cash flow projections assumed the company would pay no tax (income tax or minimum tax) until the note was paid off. After that, the profit that previously had gone to pay off the note could be retained by the company or paid out in regular dividends. After the note was paid off, all the profit would be taxed once at the corporate level and a second time when paid out as regular dividends.

ESOPs have received much congressional attention and approval. Petitioner's briefs in the lower Courts list the many tax benefits that Congress specifically granted to ESOPs. The Minimum Tax is another matter altogether. In response to reports that "there are millionaires out there who are not paying any income tax," Congress enacted the first Minimum Tax in the Tax Reform Act of 1969. At first, the Minimum Tax applied only to individuals and was relatively toothless because of the low rate and high exemptions. Gradually over the years

the Minimum Tax was overhauled, made more complicated and given more bite. The Tax Reform Act of 1986 contained the first Corporate Alternative Minimum Tax. One of the main reasons was that big corporations issued reports to their shareholders using "financial accounting" showing large earnings on their books but filed tax returns showing no Taxable Income and paying no Income Tax. The Corporate Alternative Minimum Tax was premised on the idea that if corporations had significant "Book Income" but little or no "Taxable Income" they should at least pay a minimum tax on part of their Book Income. Thus, the 1986 Tax Reform Act added Code § 56(c)(1) which provided 2 formulas for fixing this - for 1987, 1988 and 1989 the "Book Income Adjustment" under Code § 56(f) was to apply. Thereafter, the Book Income Adjustment was to be replaced by the "Adjusted Current Earnings Adjustment," or "ACE Adjustment," in Code § 56(g). The Book Income Adjustment was fairly easy to compute and administer. Presumably the more complex ACE Adjustment would be fairer and more precise. Congress gave the IRS three years advance notice to figure out the more complicated system required by the "ACE Adjustment," and publish guidance for taxpayers who would have to comply with this new tax system. Section 7611(g)(3) of OBRA directed the IRS to issue guidance to taxpayers on how to compute ACE, by March 15, 1991.

Snap-Drape closed the ESOP deal in February 1990. At that time there was no published position of the IRS indicating that § 404(k) dividends (tax deductible ESOP dividends) would not also be deductible in computing ACE. There was nothing in the statute (§ 56) or legislative history that foreshadowed the position that the IRS was going take in Reg. § 1.56(g)(4)(C)(iii); that tax deductible ESOP dividends were not deductible in computing ACE. Tax professionals, even those narrowly specialized in either employee benefit plans or

the AMT were caught completely off guard when the IRS published this Regulation in proposed form on May 3, 1990. Snap-Drape and its employees closed the ESOP loan in February 1990, relying on the position that there would be no minimum tax. The IRS published Treasury Regulation § 1.56(g)(1)(C)(iii)[2] in proposed form on May 3, 1990, two-and-one-half months after the Snap-Drape ESOP transaction was completed. The IRS published the Proposed Regulation in the Federal Register and invited public comments as required by the Administrative Procedure Act, 5 U.S.C. § 553 et seq. ("APA"), but did not follow other procedures required by the APA when adopting legislative regulations. Most notably it did not prepare a regulatory impact analysis. In fact the IRS published a preamble to the proposed regulation stating in effect that it did not need to comply with the APA because the regulation was interpretative, not legislative. When the IRS requested public comments, it got them, many of them. All were negative. The commentators did not criticize the proposed regulation merely because it was not in their client's interest, but because it was based on a fundamentally flawed application of a familiar corporate tax concept: Earnings and Profits. The regulation was simply a misstatement of law. It was supposed to be a list of items that are deductible in computing "Taxable Income" but not deductible in determining "Earnings and Profits," an arcane but fathomable proposition for tax experts. All commentators believed that § 404(k) dividends simply did not belong on that list and the IRS made a big mistake when it included them in the list.

The Regulation was not published in final form until March 15, 1991, over one year after the transaction was completed and on the same day that Snap-Drape filed its 1990

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[2] Hereinafter, the "Regulation."

Return. Snap-Drape "red flagged" the Minimum Tax issue on its return. It requested a prompt audit. The auditor, relying on the Regulation disallowed the deduction for ACE purposes and determined a Minimum Tax to be due. Snap-Drape requested a prompt appeal. The Appeals Division sustained the Audit Division's position.

On December 10, 1992 the IRS issued a Statutory Notice of Deficiency to Snap-Drape asserting a deficiency in the Minimum Tax for 1990 of $239,463. On February 1, 1993 Snap-Drape filed a Petition with the Tax Court contesting the deficiency. The case was tried before the Honorable Lawrence A. Wright on March 14, 1994. The sole issue presented to the Tax Court was whether Snap-Drape was liable for the Corporate Alternative Minimum Tax ("AMT"). Snap-Drape's case had two main elements: (1) that the regulation was invalid for two reasons (a) it was invalid as an interpretative regulation because it went beyond the Statute and (b) it was invalid as a legislative regulation because of failure to comply with APA requirements and (2) if valid, it was an abuse of discretion to apply it retroactively.

On July 13, 1995 the Tax Court filed an Opinion holding that Snap-Drape is liable for the AMT. On October 24, 1995 the Tax Court entered a Decision determining that there was a deficiency of $239,463 Minimum Tax due from Appellant for 1990.

The case was timely appealed to the United States Court of Appeals for the Fifth Circuit. On October 28, 1996 the Fifth Circuit entered a Decision holding that Treasury Regulation § 1.56(g)-1(D)(3)(iii)(E) is valid, affirming the judgment of the Tax Court.

On December 26, 1996 Appellant filed a Petition for Rehearing with the United States Court of Appeals for the Fifth Circuit. On January 13, 1997 the Petition for Rehearing was denied. The case is now properly before this Court.

Reasons for Granting the Writ

This case exposes a fundamental separation of powers problem which arises largely because of the complexity of modern life and particularly because of the complexity cf the Internal Revenue Code. In this case the IRS issued a regulation purporting to interpret a section of the Internal Revenue Code which had the effect of imposing AMT on a class of transactions which would not have been thought to be subject to the AMT under the wording of the Statute itself. Before this regulation was even proposed, Snap-Drape closed an ESOP transaction which was planned and structured to take advantage of provisions in the tax law as they were thought to exist at that time. In February 1990, it was not reasonable to anticipate that the IRS would take the position that it ultimately did. This regulation had the effect of reversing prior notions of the corporate tax concept of "Earnings and Profits" and caused quite a hardship to Snap-Drape whose transaction was closed and completed before the regulation was ever proposed. It was closed and completed in justifiable reliance on the expectation that the transaction would not attract an alternative minimum tax. The regulation not only took an unforeseeable position, but applied it retroactively as if the law had always been that way. The total unforseeability together with retroactively made it particularly harsh as applied to Snap-Drape and its employees. The Regulation depends for its validity on the definition of Earnings and Profits, and whether Section 404(k) dividends or ESOP dividends are deductible by a corporation in determining its Earnings and Profits. The Regulation listed ESOP dividends

as an item that is not deductible in determining Earnings and Profits. In this Regulation the IRS was purporting to "interpret" a statute which says that items that are not deductible for Earning and Profits purposes are also nondeductible for ACE purposes, and consequently AMT purposes. Since 404(k) dividends would have universally been regarded as deductible for Earnings and Profits purposes, the position the IRS took in this regulation can not simply be an interpretation of the Statute, but it changes the meaning of the Statute and goes well beyond what the Statute intended. Congress occasionally delegates a portion of its legislative authority to the IRS when it specifically authorizes it to issue a regulation in a certain area. See e.g.: Code § 482. But when Congress delegates legislative authority to the IRS, for the exercise of that authority to be valid, it must have been (1) pursuant to a true delegation of authority and (2) accomplished in compliance with the procedural requirements of the Administrative Procedure Act. The problem in this case is that the regulation cannot be valid as an interpretative regulation because it goes beyond the Statute, and it cannot be valid as a legislative regulation because it neither complies with APA, nor is it pursuant to a specific delegation of authority. But the tax law is so complex, that the IRS either innocently made a mistake in including ESOP dividends or it intentionally exceeded its authority. If it was intentional, the IRS sought to close a loophole that Congress did not intend to close, or impose a tax that Congress did not intend to impose, because the area was so archine and so technical that it believed that nobody would catch it. Either way, mistake or intentional, the IRS did not have authority to do what it did. That is not so uncommon, but the real problem comes when the Courts are unable or unwilling to step in and adjudicate the controversy because of their "deference to agency expertise" in interpreting the Statute.

Here we have a fundamental problem of Separation of Powers.

In 1986 Congress amended the Internal Revenue Code to subject certain transactions to the Alternative Minimum Tax under a new computational scheme known as the "ACE" regime. By 1990, U.S. corporations were required to compute their federal tax liability by determining their taxable income or "Regular Tax," then computing their liability under a different set of rules known as the Alternative Minimum Tax or "AMT," and then computing liability again under a third set of rules known as the "ACE" regime. Under ACE, beginning in 1990, transactions which involved items that are deductible for regular tax purposes but not deductible for purposes of computing Earnings and Profits were to be included in ACE, which was a component of the Corporate Alternative Minimum Tax. Congress instructed the IRS to issue regulations giving taxpayers guidance as to which items fell in that category. The deadline for issuing these regulations was March 15, 1991, the due date for 1990 tax returns. Before the IRS issued any regulations, Snap-Drape closed its ESOP transaction. This transaction was planned with tax consequences in mind and specifically, whether the corporate alternative minimum tax might apply. The ESOP transaction depended on the deductibility of certain dividends. Snap-Drape's advisors had no reason to believe that these dividends would be subject to the alternative minimum tax because the dividends are deductible for regular purposes and were also deductible in computing earnings and profits. After Snap-Drape closed the ESOP transaction, the IRS published the Proposed Regulation including § 404(k) dividends in the list of items that were deductible for Regular Tax purposes but were not deductible for Earnings and Profits purposes for any year. This regulation, if valid, had the effect of subjecting the Snap-Drape ESOP

transaction to the alternative minimum tax, retroactively, when it could not have reasonably been foreseen. This is, of course, unfair, but it also worked a hardship on Snap-Drape because the minimum tax created an unanticipated liability for Snap-Drape that caused its net worth fall below certain levels in violation of the covenants in the loan agreements. Snap-Drape could have been held in default and put out of business by the bank. Snap-Drape was able to obtain a waiver of the default and keep the business going, but it had no assurance that it would work out.

Certiorari should be granted because the Courts should not be so deferential to the IRS merely because the subject matter is archine. The complexity and infathomability of the income tax law can be a cloak behind which hides taxation not authorized by our elected representatives. Ordinary people and large corporations alike feel that because the tax law is so complicated, and the IRS is so powerful, they are powerless to disagree with the IRS, even when it takes a position that appears to be unreasonable and contrary to the law. Little erosions of the separation of powers doctrine should not be allowed to accumulate into a canyon where the doctrine no longer resides. The Court should grant certiorari because, to the parties involved in this transaction, the IRS position was unfair and worked a hardship. Whether it was an accidental or intentional misstatement of tax law, it had the effect of discouraging ESOP transactions nationwide. It was a problem not just for taxpayers contemplating ESOP transactions, but for all taxpayers who endeavor to plan their transactions so as to minimize the tax consequences. Taxpayers are entitled to rely on valid, time tested understandings of how the tax law works. Here the IRS changed the law, changed it in a way that could not be anticipated, and where there was no apparent authority for doing so, and applied the change retroactively. If it gets by with it on the grounds that the tax law is so complicated that the Courts will defer to the IRS expertise in interpreting the tax

law, then the IRS has sucessfully purloined the legislative authority to levy taxes, and the Courts have abdicated their role in policing the Separation of Powers Doctrine. This is an important case and this Court must accept its responsibility to keep the Separation of Powers Doctrine alive and well.

A. **The IRS Was Wrong and The Courts were Wrong When They Deferred to the IRS Position.** This case is all about the ACE Adjustment and whether a regulation adopted by the Internal Revenue Service imposing a minimum tax on companies having ESOPs such as this one is an improper intrusion by the Treasury Department into the domain of Congress. By this Regulation, Snap-Drape contends, the Treasury nullified or repealed a significant tax benefit for ESOPs under Code § 404(k). The Regulation disallows the deduction of § 404(k) dividends for Alternative Minimum Tax purposes. Treas. Reg. § 1.56(g)-1(d)(3)(iii)(E). Here we have a clash of two congressional schemes: the deliberate granting of tax benefits to ESOPs and the deliberate withdrawal of tax benefits from large corporations that pay no tax. The lower courts deferred to the IRS because of the technicality of this area of the law. In so doing, the Courts not only committed error, but they let the IRS get by with rewriting the tax code without any direction from Congress. Who is affected by this? Of course, Snap-Drape, the taxpayer, and its employees. Who else? The other companies that adopted ESOPs in reliance on the deductibility of Section 404(k) dividends before the Regulation was published . Who else? The many other companies and their employees who were discouraged from adopting ESOPs by the Regulation because they determined that they could not afford an ESOP and the AMT too. Who else? The entire community of tax professionals who plan, negotiate, structure, and document personal, family, and business transactions everyday in reliance upon the body of

Federal Common Law of Taxation, and in particular, upon the body of law dealing with the concept of "Earnings and Profits." If the IRS can legislate (and that is what it did here) a change in the tax law as fundamental as the computation of Earnings and Profits, without a specific direction from Congress, then there is no business transaction that can safely be planned by any taxpayer. Not only can the IRS change the rules of the game in the middle of the game, it can change them after the game is over, and declare itself the winner. By claiming that the regulation is "legislative" it avoids significant judicial review. By claiming that the regulation is "interpretative" it avoids subjecting the regulation to the analysis required of it under the Regulatory Flexibility Act. The IRS is trying to have it both ways, but it cannot. While this is onerous for all businesses, it is particularly so for small businesses.

1. **The IRS is wrong**. Before the IRS adopted this regulation, virtually all the corporate tax professionals had a good general idea of the concept of "Earnings and Profits." Earnings and Profits is a concept that is crucial to the understanding of, and the ability to plan, corporate transactions. The ability to compute Earnings and Profits with relative certainty is necessary for rational business planning. Earnings and Profits was never defined in the Internal Revenue Code; it was simply a term used by Congress in the earliest revenue acts, and it has been carried over to successive acts. It is essentially the measure of a corporation's dividend paying capacity. The term has been construed in many cases over the years and there is a fairly significant and stable body of case law which gives meaning to the term Earnings and Profits. This body of law gives predictability to business transactions. When the IRS says that § 404(k) dividends are not deductible in determining Earnings and Profits (that is what the Regulation does), the IRS position is turning eight decades of tax law on its ear.

The taxpayer offered two expert witnesses to show that at the time this ESOP transaction was done (before the Regulation was even proposed) the tax community could not foresee that a Minimum Tax would be imposed. The prevailing view was that these 404(k) dividends would be deductible in determining Earnings and Profits. In an odd procedure, the Tax Court rejected this expert testimony. It is normal practice in the Tax Court for the parties to proffer their experts sufficiently in advance of trial to allow the other side to prepare to cross examine them. The Tax Court requires that the experts prepare written reports which are exchanged prior to trial. At the time of trial, the expert is placed on the stand and asked to identify his report. The report is deemed the direct examination of the expert. The expert is then turned over for cross examination. In this case, the experts were timely identified, and their reports were timely furnished to the Commissioner. On the eve of trial the Commissioner filed a "Motion in Limine." The Court ruled that it would wait until after the trial to rule on the Motion in Limine. It then proceeded to try the case, "received" the expert reports, but did not admit them or reject them. It did not permit Counsel who proffered the experts to examine them. It allowed government Counsel to extensively cross examine the experts. After the case had been fully briefed, several months after the trial, the Court issued its Opinion in which it announced for the first time that it was going to reject the testimony of the experts. Counsel would be screaming more loudly about this odd procedure if it were not for the fact that the Fifth Circuit, which did not reverse the Tax Court for excluding the expert reports, seemed to adopt nearly every idea expressed by the Taxpayer's experts.

The Fifth Circuit Opinion is basically an apology for a counter-intuitive result. There are two assumptions that seem to underlie this apologetic opinion: (1) This is a very technical area of the law, and in technical areas, the courts accord great

deference to the expertise of the agency. (2) Congress told the IRS to issue this regulation (See: Section 7611(g)(3) of OBRA 1989), and when Congress tells the IRS to issue a regulation, that makes the regulation legislative instead of interpretive. The courts have seen many challenges to IRS regulations and there are factors which are peculair to tax cases, that sometimes the courts forget that the IRS, like all other executive agencies, is required to follow the Administrative Procedure Act. A valid delegation of legislative authority must comply with the Administrative Procedure Act and is an exception to the general rule of separation of powers, and must not be abused. Most IRS Legislative Regulations are issued pursuant to a specific Congressional directive, but it is not the directive that makes it legislative. It is the delegation of authority which makes a regulation legislative, and that delegation is absent in § 7611(g)(3) of OBRA.

This Petition will not restate all the technical arguments that show why the basic position of the IRS is wrong. The entire record in the Tax Court and the Fifth Circuit show this. The expert reports, whether "admitted" into evidence or not, were received by the Court and are in the record. They were appended to Appellant's brief in the Fifth Circuit. The expert reports, the briefs of Counsel, and the Opinion of the Fifth Circuit, all show that the IRS position was not a correct interpretation of the existing law. The IRS position was a definite change in the law of computing Earnings and Profits. It was an unforeseeable change, not supported by any prior authority. In APA parlance it was "Rulemaking." It can only be sustained if it was (a) pursuant to a lawful delegation of legislative authority and (b) adopted procedurally correctly, in compliance with the Administrative Procedure Act. It was neither. The lower court briefs explain why, fully.

2. **Undue Deference to the IRS**. The general notion of deference to agency expertise is not being challenged. What is being challenged is undeserved and undue deference to agency action simply because the agency is usually correct and the area is very technical. The Internal Revenue Code is enormously complicated, and the ever-so-frequent amendments, reform acts, budget reconciliation acts, technical corrections acts and the like, make it ever harder to keep up. What is the law one year isn't the law the next. The effective dates of changes do not always coincide with calendar years or taxable years. The body of tax law includes not only the Code, but official IRS publications, Private Letter Rulings, internal memoranda and rulings not available to the public, published rulings, interpretive regulations, legislative regulations, statements of procedural rules, and an enormous amount of case law. Federal Tax Law is so enormous and complex that no one can know it all. There are subspecialties in corporate taxation, S-corporation taxation, partnership taxation, real estate taxation, insurance company taxation, banking taxation, estate and gift taxation, foreign tax problems of American corporations, U.S. tax problems of foreign corporations, international pricing disputes, executive benefits, qualified plans, and on and on. Intelligent people with first rate tax advisors can make mistakes or differ in their judgment about the tax consequences of various transactions. Just ask the Speaker of the House and the President of the United States. Tax law is so complicated and interconnected that when Congress enacts a tax bill, it relies on the tax-writing committees of Congress, and those committees rely on their professional staffs, to translate policy decisions into legislation. Those staffs include some of the finest and most experienced tax professionals in the land and some of the greenest and most inexperienced law school graduates, all of whom are honestly trying to do what they believe to be their job. The Office of Chief Counsel of the IRS is staffed by both

experienced tax lawyers and rookies. They are all well motivated. But the Ways and Means Committee staff lawyer, or the IRS Chief Counsel attorney, seems always to become an advocate for the Government. If there is doubt as to whether Congress intended a loophole, take the position that it did not. If Congress clearly did intend to create a loophole, construe it as narrowly as possible. This is probably a good bias, but occasionally, something goes wrong. The best intentioned attorney who is given a regulations project like this could simply make a mistake in deciding that Section 404(k) dividends should be listed along with other items that are not deductible for Earnings and Profits purposes. This mistake would not be obvious to someone who was not heavily involved in planning an ESOP transaction. Even if it is a mistake, it is not totally obvious that it is a mistake. It certainly would be a revenue raiser. The buck gets passed up the chain of command, and the original thinking becomes more obscure. The original mistake gets entrenched as the position of the IRS. Mistakes like this can go all the way through the system without getting filtered out. The system is designed to keep that from happening, and most of the time it works. But when it does not, it is the job of the courts to step in and set things straight. They must not pay undue deference to the agency when it very clearly has made a mistake. The excuse that "this is a very technical area" is not good enough when the evidence and logic both show that the IRS made a mistake. This Court should step in when the mistake has far reaching consequences.

3. **Section 7611(g)(3) of OBRA was not a delegation of Legislative Authority**. The Fifth Circuit said that the regulation was contrary to prior understandings of the concept of earnings and profits, it was unforseen and unforeseeable, and it brought about a harsh result. Nevertheless it would be

sustained because it is a "legislative" regulation, and it could be applied retroactively because IRS regulations are presumptively retroactive under Internal Revenue Code § 7805. Of course, presumptive retroactivity under § 7805 applies only to **interpretive** regulations, but that detail can be overlooked. Why did the lower courts hold that it is a legislative regulation? Because Congress told the IRS to issue the regulation in § 7611(g)(3) of OBRA. They assumed that whenever Congress tells the IRS to issue a regulation, it must be a legislative regulation. Did Congress really delegate to the IRS the authority to change the law in the area of Earnings and Profits? NO. Did Congress tell the IRS to issue this regulation? YES. Why? Because the area is complicated, and taxpayers need guidance. Even Ways and Means Committee staff members, and IRS Chief Counsel attorneys, could make a mistake if they were asked to generate a list of all the items in the Internal Revenue Code that are deductible by corporations for regular tax purposes but that are not deductible for computing earnings and profits. Taxpayers need guidance to comply with this overly arcane law. Congress passed the law and directed IRS to give taxpayers guidance in complying with it, Congress did not give IRS the authority to change it.

In 1986, when Congress passed the Tax Reform Act, it chose two formulae for extracting the Minimum Tax from profitable corporations that paid no regular income tax: first: the Book Income Adjustment, which was relatively simple to compute, applied for the first three years, 1987, 1988 and 1989. The ACE Adjustment was going to go into effect for 1990 and later years. The ACE Adjustment served the same purposes as the Book Income Adjustment; it was more complicated, but presumably, fairer. By 1989 the IRS still had not issued any interpretive regulations explaining how the ACE Adjustment would work. A long standing practice has grown up in the tax

field whereby the IRS will issue interpretative regulations, even under fairly self-explanatory Internal Revenue Code sections. These Regulations are supposed to illustrate the way the Code Sections work. The Code section involved in this case, § 56(g)(4)(C)(1), basically says that when a corporate taxpayer fills out its 1990 or later tax return, it must go back through all the deductions it has taken and ask a question about each one. That question is: Is this item not only deductible in determining Taxable Income, but is it also deductible in determining Earnings and Profits? If the answer to that question, with respect to any item is no, then the taxpayer must go through a process of computing its ACE, to see if it has any AMTI, to see if it owes any Alternative Minimum Tax. Most corporate tax return preparers had never gone through such an exercise before, because the law had never required them to do so before. It is quite natural to expect that unless the IRS went through the exercise for them and listed the items that might come up, tax return preparers might miss some items that should have gone into the ACE computation. In 1989, three years after the law was passed, the IRS still had failed to issue any guidance. So in 1989 Congress told the IRS to issue regulations by March 15, 1991 (the due date for 1990 returns - the first year to which the ACE adjustment applies). The Regulations were supposed to be guidance as to how to apply the ACE adjustment. Although the Internal Revenue Code may at times seem unfathomable, a careful reading of Code § 56(g)(4)(C)(iii) (denial of deductions for ACE purposes if they are not deductible for E & P purposes) and Code § 56(g)(5)(A) (Definition of Earnings and Profits - it means the same as for regular tax purposes) makes it pretty clear that Congress was not telling the IRS that it had the authority to change the meaning of Earnings and Profits, but was simply telling the IRS to list things that would be included or excluded in computing Earnings and Profits under existing tax practice. Section

7611(g)(3) of OBRA is not a delegation of legislative authority. That is plain on its face. It is nothing more than a direction to issue helpful interpretative regulations. Those helpful regulations were due to be issued by the due date for tax returns for 1990. They wouldn't be too much help unless the taxpayer extended his tax return past the due date. And they certainly wouldn't be helpful for taxpayers who engaged in a 1990 transaction, changing their position to their detriment, relying on the assumption that Earnings and Profits was going to have its usual and accepted meaning for Minimum Tax purposes as well as Regular Tax purposes. Code § 56(g)(5) says that Earnings and Profits have the same meaning as in Subchapter C. That was its usual and accepted meaning as spelled out in the case law. The regulation was not to be a pronouncement of new law, a change in the way of computing Earnings and Profits. It was merely to be an interpretative regulation giving guidance on how to compute the ACE adjustment under well established principles of existing law.

4. **Even if Congress intended to delegate legislative authority to the IRS, the IRS did not follow the required procedures under the Administrative Procedure Act and the Regulation is void**. The Administrative Procedure Act, 5 U.S.C. § 553 et seq. was adopted in 1946. The Senate Judiciary Committee Report (S. Rept. No. 79th Cong., 1st Sess.) states (page 1):

> There is widespread demand for legislation to settle and regulate the field of Federal Administrative Law and Procedure. The subject is not expressly mentioned in the Constitution, and there is no recognizable body of such law, as there is for courts in the Judicial Code. There are no clearly recognized legal guides for either

> the public or for the administrators. Even the ordinary operations of administrative agencies are often difficult to know. The Committee on the Judiciary is convinced that, at least in essentials, there should be some simple and standard plan of administrative procedure.

The House Committee on the Judiciary Report on the bill states:

> The bill is an outline of minimum essential rights and procedures. Agencies may fill in details, so long as they publish them. It affords private parties a means of knowing what their rights are and how they may protect them, while administrators are given a simple framework upon which to base such operations as are subject to the provisions of the bill.
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> * * *
>
> The public information section is basic, because it requires agencies to take the initiative in informing the public. In stating the essentials of the different forms of administrative proceedings, the bill carefully distinguishes between the so-called legislative functions of administrative agencies (where they issue general regulations) and their judicial functions (in which they determine rights or liabilities in particular cases.) It provides quite different procedures for the "legislative" and "judicial" functions of administrative agencies. In the "rule making" (that is, "legislative") function it provides that with certain exceptions agencies must publish notice and at least permit interested parties to submit their views in

> writing for agency consideration before the issuance of general regulations.

Report of the House Committee on the Judiciary, H.R. Rep. No. 1980, May 3, 1946.

The notice and comment provisions of the APA are the most familiar aspect of the requirements on an agency when exercising its legislative functions. In the 1970s, however, Congress and the President realized that government regulation that might be acceptable to big businesses in many instances placed an undue drain on the resources of smaller businesses. Thus the Regulatory Flexibility Act came about as an amendment to the APA. The main features of the Regulatory Flexibility Act were to require agencies to prepare a Regulatory Impact Analysis of how proposed regulations would impact small businesses and to require that all proposed regulations be submitted to the administrator of the SBA for his input. 5 U.S.C.A. § 603(a).

The IRS issues both interpretative regulations and legislative regulations. It has the authority to issue interpretative regulations under Internal Revenue Code § 7805. These regulations are presumptively retroactive, because they are not declaring new law or changing old law, but are merely declaring what the law has always been. When the IRS issues legislative regulations, it, like all other government agencies, is required to follow the Administrative Procedure Act. The IRS customarily publishes even its interpretive regulations in the Federal Register and seeks public comments. This is a good practice and the IRS is doing more than it is required to do in this regard. But when the IRS proposes a legislative regulation, it must follow the Administrative Procedure Act, as amended by the Regulatory Flexibility Act. It must not only publish the

regulation in advance, and seek public comments, it must also submit the regulation to the administrator of the SBA and prepare a regulatory flexibility analysis. 5 U.S.C.A. § 603(a). This the IRS did not do. If this regulation were truly interpretive, and merely declared what prior law already was, then it would make no difference if it failed to prepare a regulatory flexibility analysis and follow all the procedures of the APA to the letter. 5 U.S.C.A. § 553(b), § 603(a). This regulation, however, does not simply declare what the law always was on computing Earnings and Profits. It is a totally unforeseeable departure from all prior notions of how Earnings and Profits is computed. If this regulation is to have the force of law, it can only be if Congress clearly delegated the authority to make this law and if the IRS followed the procedures set forth in the APA. Neither of those things happened here. Congress did not tell the IRS that it had the authority to change the law on Earnings and Profits. Congress simply told the IRS that it was required to give taxpayers a useful list of which items were included and which items were excluded in computing Earnings and Profits. This was not a delegation of authority to change the tax laws, much less a direction to do so. What the IRS did was to legislate. All the government briefs rely on the proposition that the Regulation is legislative, specifically authorized by OBRA. They are correct that it is legislative. They are incorrect that it was authorized by OBRA. The IRS did not submit a Regulatory Flexibility Analysis as it must when adopting legislative regulations. It states so in the preamble to the proposed regulation that was published in May of 1990 T.D., 1990-1 C.B. 663, 667, and in the preamble to the final regulation when it was issued in March of 1991. T.D., 1991-1 C.B. 4, 7. If for no other reason, this "technicality" invalidates the Regulation.

B. Importance of the issue and consequences for tax

planning. Why should the Court hear this case? Because it is important to Snap-Drape, and the lower court decisions hurt that company and its employees? No. Because this regulation hurts other companies that adopted ESOPs before the regulation was ever proposed, in reliance on well established law? No. Because the many employees of companies that adopted ESOPs before the regulation was proposed have been hurt? No. Because employees of many other companies got no ESOP or reduced benefits? No. All of this is true, but it may not be enough to justify Certiorari. Selling shareholders of hundreds of companies that were sold to ESOPs lost some of the tax benefits they anticipated when they sold their stock. Hundreds of thousands of employees of companies that were owned in whole or in part by ESOPs lost part or all of their retirement benefits because of this law. Is this enough to grant Certiorari? Why should the court hear this case? Because all of the foregoing is true. But more fundamentally, the Snap-Drape case undermines confidence in the tax system generally. No individual or corporation can safely plan a business transaction, relying upon the finest legal and accounting advice that money can buy, when the courts will permit the IRS to change the law, change it retroactively, and impose entirely unanticipated tax burdens on transactions, after the fact, where none of the parties in their wildest imagination could have ever dreamed that the transaction would be subjected to those tax consequences.

This regulation is a change in the law. It could either be intentional on the part of the IRS to change the law, or it could simply be a mistake by the IRS when it thought it was interpreting the existing law. It really doesn't matter. It is a change in the law, and in order for it to be sustained, it must have (1) been a result of a specific delegation of congressional authority and (2) have been adopted in accordance with the Administrative Procedure Act. Since it was neither, it cannot

be sustained. It is not and cannot be sustained as a valid interpretive regulation because it does not declare the law as it existed before, but is a distinct departure from and reversal of prior law.

Conclusion

The Petition for Writ of Certiorari should be granted. The judgment of the Court of Appeals for the Fifth Circuit should be reversed and judgment should be entered for the Petitioner.

Respectfully submitted,

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APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT DATED OCTOBER 28, 1996

UNITED STATES COURT OF APPEALS,
FIFTH CIRCUIT.

Oct. 28, 1996.

No. 95-60699.

SNAP-DRAPE, INC.,

Petitioner-Appellant.

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Taxpayer challenged determination of Commissioner of Internal Revenue that taxpayer incorrectly computed its corporate alternative minimum taxable income. The United States Tax Court, 105 T.C. 16, Wright, J., entered judgment for Commissioner and taxpayer appealed. The Court of Appeals, Wiener, Circuit Judge, held that: (1) trial court did not abuse its discretion in refusing to admit expert testimony; (2) Treasury Department regulation prohibiting deduction of dividends paid to employee stock ownership plan when calculating earnings and profits and, thus in computing adjusted current earnings for purposes of alternative minimum tax was not arbitrary, capricious or contrary to statute; and (3) Secretary of Treasury did not abuse its discretion by not limiting effect of regulation to prospective only.

Affirmed.

Appendix A

* * *

John David Copeland, Wilson, White & Copeland, Dallas, TX. for petitioner-appellant.

Gary R. Allen, Frank P. Cihlar, Kenneth L. Greene, Loretta Argrett, Asst. Atty. General, U.S. Department of Justice, Tax Division, Appellate Section, Washington, DC, for respondent-appellee.

Appeal from the United States Tax Court.

Before KING, SMITH and WIENER, Circuit Judges.

WIENER, Circuit Judge:

This federal income tax case presents two questions: (1) whether Treasury Regulation § 1.56(g)-l(d)(3)(iii)(E) is valid to the extent it provides that dividends paid to an Employee Stock Ownership Plan and deductible for regular income tax purposes, cannot be deducted in calculating earnings and profits (E & P) and thus in computing "adjusted current earnings" (ACE) for purposes of the corporate alternative minimum tax (AMT); and (2) if valid, whether retroactive application of that regulation was proper. The Tax Court concluded that the regulation in question is valid and that the Secretary of the Treasury had not abused his discretion in failing to limit the subject regulation's effect to prospective only. Agreeing with the Tax Court that the regulation is valid and that its retroactive application is not inappropriate, we affirm.

Appendix A

I

FACTS AND PROCEEDINGS

Petitioner-Appellant Snap-Drape, Inc. (Taxpayer) is a Texas corporation engaged principally in manufacturing and marketing table skirting for buffet tables, banquet tables, conference tables, and the like. Prior to February 1990, the founders of Taxpayer—Raymond Belknap and Gerald Guebert—owned, in equal portions, all of the outstanding common stock of the corporation.

In late 1988 or early 1989, Belknap and Guebert decided to sell their interests in Taxpayer and retire. The two founders explored a number of ways to dispose of their stock, none of which proved to be satisfactory. In November 1989, Belknap and Guebert began serious consideration of creating an employee stock ownership plan to which they could sell their stock. Uncontradicted testimony in the record reflects that the plans of Belknap and Guebert were well underway prior to the December 19, 1989 enactment date of the Omnibus Budget Reconciliation Act of 1989 (OBRA),[1] not to mention the issuances of the proposed and final versions of the subject regulation.

On February 1, 1990, Taxpayer established the Snap-Drape, Inc. Employee Stock Ownership Plan and Trust (the ESOP). Later that same month, the ESOP agreed to purchase approximately 80 percent of Belknap's and Guebert's Snap-Drape common stock for a total of $5,000,000. To make this stock purchase possible, the ESOP obtained a $5,000,000 bank loan which Taxpayer was required to guarantee. The reason

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1. P.L. No. 101-239, 103 Stat. 2106 (1989).

that the ESOP purchased no more than 80 percent of Taxpayer's issued and outstanding stock was that the bank refused to finance a larger purchase: An analysis of Taxpayer's cash flow indicated that $5,000,000 was the maximum amount of debt that the corporation could service, and then only if the note payments could be made with "pre-tax dollars."

Among other things, the ESOP's note to the bank provides for mandatory annual prepayments of principal. The amount of each such prepayment is to be calculated by a formula based on Taxpayer's cash flow.

During its 1990 taxable year, Taxpayer made a qualifying contribution of $240,732 to the ESOP. An income tax deduction for this entire amount was taken pursuant to I.R.C. § 404(a); it was the maximum contribution that Taxpayer could make to such a plan that year and still obtain a tax deduction. In addition, however, Taxpayer paid $1,440,000 in cash as dividends on the shares of its stock held by the ESOP.[2] In turn, the ESOP used funds received as dividends to make payments on the loan that it had taken out to acquire the stock, so Taxpayer was permitted to deduct the $1,440,000 from its taxable income pursuant to I.R.C. § 404(k).[3] In computing its AMT, Taxpayer made no adjustment with respect to either the § 404(k) dividends or the § 404(a) contribution to the ESOP. Accordingly, Taxpayer reported on its 1990 income tax return that it was not liable for any AMT.

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2. In the agreement to sell their stock to the ESOP, Belknap and Guebert agreed to waive all dividends on the stock that they retained until such time as the ESOP's note was paid in full. Accordingly, no dividends were paid to Belknap or Guebert in 1990.

3. See I.R.C. § 404(k)(2)(A)(iii). The mandatory prepayment of principal due under the ESOP's note for 1990 was $569,123.

Appendix A

On May 3, 1990—a few months after Taxpayer formed the ESOP, and after the ESOP entered into both the stock purchase and the loan agreements—the Treasury Department published a proposed regulation that for the first time ever would disallow a deduction for § 404(k) dividends for purposes of determining corporate earnings and profits (E & P) as used in computing ACE under the corporate AMT regime. Almost a year later, on March 15, 1991, Treasury Regulation § 1.56(g)-1(d)(3)(iii)(E) was published in final form, effective retroactively for all taxable years beginning after December 31, 1989. As Taxpayer's taxable year is the calendar year, retroactivity would cause that regulation to affect Taxpayer for 1990.

Based on the authority of this regulation, Respondent-Appellee Commissioner of Internal Revenue (the Commissioner) applied it retroactively and determined that Taxpayer incorrectly computed its alternative minimum taxable income (AMTI) and owed $210,613 in AMT for its 1990 tax year. Taxpayer challenged the Commissioner's determination in the Tax Court, objecting to the validity of the regulation and its retroactive application.

In support of its position that § 404(k) dividends are properly deductible in computing ACE, Taxpayer sought to introduce two expert witness reports that reach this same conclusion. The Tax Court, however, did not admit these reports into evidence as it determined that the reports contained legal rather than factual conclusions. The Tax Court went on to hold that the regulation in question was valid and that its retroactive application was proper. Taxpayer now appeals.

Appendix A

II

ANALYSIS

A. STANDARD OF REVIEW

The decision whether to admit expert testimony is entrusted to the sound discretion of the trial court. Such an evidentiary ruling is reversible on review only for an abuse of that discretion.[4]

In assessing the validity of a Treasury regulation, the standard of review depends on whether the regulation is legislative or interpretive. A legislative regulation is given controlling weight unless it is "arbitrary, capricious, or manifestly contrary to the statute."[5] An interpretive regulation, on the other hand, is accorded less deference, but is nevertheless valid if it is a reasonable interpretation of the statute and if it "harmonizes with the plain language of the statute, its origin, and its purpose."[6]

Failure of the Secretary of the Treasury to limit a regulation to prospective application is reviewable for an abuse of discretion.[7]

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4. United States v. Charroux, 3 F.3d 827, 833 (5th Cir.1993).

5. Dresser Indus. v. Commissioner, 911 F.2d 1128, 1137 (5th Cir.1990) (citing Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844, 104 S.Ct. 2778, 2782, 81 L.Ed.2d 694 (1984)).

6. Id. at 1137-38 (quoting Rowan Companies v. United States, 452 U.S. 247, 252, 101 S.Ct. 2288, 2292, 68 L.Ed.2d 814 (1981)).

7. Anderson, Clayton & Co. v. United States, 562 F.2d 972, 979 (5th Cir.1977), cert. denied, 436 U.S. 944, 98 S.Ct. 2845, 56 L.Ed.2d 785 (1978).

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B. EXCLUSION OF EXPERT WITNESS REPORTS FROM EVIDENCE

Both of the two expert witness reports offered by Taxpayer, which the Tax Court refused to admit into evidence, are in the form of letters from certified public accountants and contain analyses that lead to the conclusion that § 404(k) dividends are deductible for purposes of computing ACE. Each report also concludes that the position taken by the Treasury Department in Regulation § 1.56(g)-1(d)(3)(iii)(E) was not reasonably foreseeable before it was published in proposed form on May 3, 1990.

In refusing to admit these expert witness reports into evidence, the Tax Court determined that they improperly contain legal conclusions and statements of mere advocacy. The Tax Court further concluded that the reports would be of no assistance in making findings of fact.

Taxpayer asserts on appeal that the two expert witness reports should have been admitted as they show (1) the proper treatment of § 404(k) dividends for tax accounting purposes and (2) the reasonable reliance by Taxpayer on its tax advisors at the time that it entered into the ESOP transaction, months before publication of the proposed regulation. Taxpayer further asserts that, as Federal Rule of Evidence 704(a) supports the admission of these reports, the Tax Court abused its discretion in refusing to admit them into evidence. We disagree.

The Tax Court accurately described the expert witness reports at issue as consisting of nothing more than legal arguments. We must conclude, therefore, that Taxpayer's reliance on Rule 704(a) is misplaced. We have repeatedly held that this

rule does not allow an expert to render conclusions of law.[8] In any event, we conclude that the Tax Court did not abuse its discretion in not admitting the expert witness reports into evidence.[9]

C. VALIDITY OF REGULATION

1. Legislative or Interpretive Regulation?

As a threshold matter, we must determine whether regulation § 1.56(g)-1(d)(3)(iii)(E) is legislative or interpretive. A legislative regulation is one that is "issued under a specific grant of authority to prescribe a method of executing a statutory provision."[10] In contrast, an interpretive regulation is one that is promulgated pursuant to the Treasury's general authority under I.R.C. § 7805 to prescribe regulations.[11] As explained above, courts must accord a higher degree of deference to a legislative regulation than to an interpretive one.

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8. E.g., Alldread v. City of Grenada, 988 F.2d 1425, 1436-37 (5th Cir.1993); Owen v. Kerr-McGee Corp., 698 F.2d 236, 240 (5th Cir.1983). See Fed.R.Evid. 704(a) ("testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact.") (emphasis added).

9. See United States v. Milton, 555 F.2d 1198, 1203 (5th Cir.1977) ("expert opinion may still be excluded . . . if the trial court determines that the expert's specialized knowledge will not assist the trier of fact to understand the evidence.").

10. Dresser Indus. v. Commissioner, 911 F.2d 1128, 1137 (5th Cir.1990) (internal quotations and citations omitted).

11. Id.

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When Congress adopted OBRA in 1989, it made a number of changes to the AMT. Of significance to our inquiry is OBRA § 7611(g)(3) which provides: REGULATIONS ON EARNINGS AND PROFITS RULES. — Not later than March 15, 1991, the Secretary of the Treasury or his delegate shall prescribe initial regulations providing guidance as to which items of income are included in adjusted current earnings under section 56(g)(4)(B)(i) of the Internal Revenue Code of 1986 and which items of deduction are disallowed under section 56(g)(4)(C) of such Code.[12]

Based on that provision, the Tax Court determined that the regulation in question is legislative rather than merely interpretive.

Not surprisingly, Taxpayer contends that the Tax Court erred in this conclusion. Specifically, Taxpayer asserts that Congress merely directed the Treasury Department to furnish "guidance" and did not delegate authority to decide which items were or were not deductible in determining E & P and, in turn, ACE. Accordingly, Taxpayer insists that the regulation in question is an interpretive regulation and thus entitled to less deference. We are not persuaded.

Taxpayer cites no authority for its contention that the wording of OBRA § 7611(g)(3) makes the regulation in question an interpretive one, and we have found none on our own. Although Taxpayer would make much over OBRA's use of the word "guidance," that alone is not nearly enough to transform the instant legislative regulation into an interpretive

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12. Omnibus Budget Reconciliation Act of 1989, P.L. No. 101-239, § 7611(g)(3), 103 Stat. 2106, 2373 (emphasis added).

one. To the contrary, we are convinced that a fair reading of OBRA § 7611(g)(3) makes clear that Congress specifically delegated authority to the Treasury to issue the regulation in question.

This reading also comports with our prior holdings.[13] We acknowledge that a regulation issued pursuant to a specific directive may nevertheless be interpretive to the extent that it exceeds Congress's specific grant of authority,[14] but that is not the case here. The regulation in question addresses the very subject matter of OBRA § 7611(g)(3)'s directive. We conclude that the regulation at issue is legislative and thus entitled to the greater degree of deference spelled out above.

2. Regulation Valid Exercise of Authority?

Before analyzing the validity of Treasury Regulation § 1.56(g)-1(d)(3)(iii)(E), we briefly survey the AMT regime so that the context in which we make such an analysis may be better understood.

a. Alternative Minimum Tax

The AMT was enacted by Congress in an attempt to ensure that taxpayers with significant levels of economic income pay at least a minimum amount of tax on that income.[15] To achieve

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13. See, e.g., Anderson, Clayton & Co. v. United States, 562 F.2d 972, 976 n. 6 (5th Cir.1977) ("regulations issued pursuant to a specific statutory authorization are clearly legislative.").

14. See Dresser, 911 F.2d at 1138 (a court must "examine both the statutory language and the regulation itself to determine if in fact the agency has engaged in rulemaking under a specific or general grant of authority.").

15. See S. REP. NO. 313, 99th Cong., 2d Sess. 518 (1986) (discussing the objectives of the alternative minimum tax).

this goal, some items that are permitted deductions or exclusions from income under the regular income tax regime are not available in computing AMTI. For example, tax-exempt interest on particular private activity bonds—an item that is excluded from regular taxable income—is not excluded from alternative minimum taxable income.[16] Similarly, accelerated depreciation on designated kinds of property, an item that is an allowed deduction for regular income tax purposes, is not permitted for purposes of AMT.[17] The regulation we review today seeks to ascribe that same treatment to dividends paid to ESOPs under § 404(k).

Once AMTI for corporations is computed, a flat rate of 20 percent is applied to calculate the taxpayer's "tentative minimum tax."[18] Finally, a corporate taxpayer owes AMT only to the extent that the corporation's tentative minimum tax exceeds its regular tax liability.[19]

b. ACE Adjustment

One of the adjustments that must be made when computing AMTI for corporations involves ACE.[20] To the extent that ACE exceeds AMTI (as calculated to that point), an adjustment equal to 75 percent of this excess is added to AMTI.[21] For computing

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16. I.R.C. § 57(a)(5).

17. See I.R.C. § 57(a)(6).

18. I.R.C. § 55(b).

19. I.R.C. § 55(a).

20. I.R.C. § 56(g).

21. I.R.C. § 56(g)(1).

ACE, § 56(g)(4)(C)(i) provides that "[a] deduction shall not be allowed for any item if such item would not be deductible for any taxable year for purposes of computing earnings and profits."[22] Section 56(g)(5)(A) defines the term "earnings and profits" to mean "earnings and profits computed for purposes of subchapter C."

Regulation § 1.56(g)-l(d)(3)(iii)(E) expressly lists dividends deducted under § 404(k) as not being deductible for purposes of computing E & P. Thus, this regulation had the effect of increasing Taxpayer's 1990 AMTI by $1,080,000,[23] resulting in an AMT liability, when combined with Taxpayer's other income and adjustments, of over $210,000.

c. Earnings and Profits

As is apparent from the language of § 56(g)(4)(C)(i), the ACE adjustment with respect to § 404(k) dividends depends on the treatment of those dividends for the purposes of computing E &P. Historically, E & P is a corporate tax concept which predates the AMT. Although the Internal Revenue Code does not comprehensively define the term "earnings and profits," I.R.C. § 312 and the regulations thereunder provide the manner in which a number of items are treated for purposes of calculating E & P.

The concept of E & P is best understood as a measure of a corporation's ability to make distributions in excess of its

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22. I.R.C. § 56(g)(4)(C)(i) (emphasis added).

23. $1,440,000 § 404(k) dividend x 75% ACE adjustment.

shareholders' initial investments.[24] Accordingly, E & P is similar, but not identical, to the "economic income of the corporation available for distribution to its shareholders."[25] This is the reason that tax-exempt interest income, which is excluded from regular taxable income, is not excluded in computing E & P: Tax-exempt income increases the ability of a corporation to make a distribution in excess of shareholders' initial investment.[26] Other "artificial" deductions, such as the dividends received deduction, which are allowed for regular income tax purposes but do not impair the ability of the corporation to make such distributions, are not taken into account in computing E & P.[27]

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24. See 10 MERTENS LAW OF FEDERAL INCOME TAXATION § 38C.01, at 3 (1991). For example, earnings and profits is used to determine whether a distribution is treated as dividend income or as a return of capital. See I.R.C. §§ 301(c), 316.

25. See CONFERENCE REPORT ON THE TAX REFORM ACT OF 1984, H.R. REP. NO. 861, 98th Cong., 2d Sess. 184 (1984) ("In general, a corporation's earnings and profits are intended to be a measure of the economic income of the corporation available for distribution to its shareholders.").

26. See Treas.Reg. § 1.312-6(b).

27. The dividends received deduction (DRD) allows a corporation to deduct all or a portion, depending on its ownership interest in the distributing corporation, of the dividend income that it receives. See I.R.C. § 243. The purpose of the DRD is to help prevent the normal corporate income tax scheme of double taxation from becoming one of triple or more taxation when dividend income passes through multiple corporations before reaching the ultimate noncorporate shareholder. The DRD thus may be viewed as an "artificial" deduction as this deduction does not decrease the economic wealth of the corporation. The same cannot be said for § 404(k) dividends.

d. Treatment of § 404(k) Dividends in Computing E & P

Although Taxpayer presents a number of arguments for its contention that § 404(k) dividends should be deductible in computing E & P, we focus only on those that we deem meritorious.

The Commissioner and Taxpayer agree on two general principles: (1) "Ordinary" dividends (as distinguished from § 404(k) dividends) are not deductible in computing E & P,[28] and (2) sums paid as compensation to employees are deductible in computing E & P. The reason that "ordinary" dividends are not deductible in computing E & P is that they are distributions out of E & P.[29] In other words, "ordinary" dividends may be viewed as distributions of economic income, not a component used to compute economic income. Compensation, on other the hand, is a true economic expenditure which is a component used to determine economic income.

This distinction between regular dividends and employee compensation is the foundation on which Taxpayer constructs its insistence that the regulation in question is invalid. Taxpayer asserts that, in substance, § 404(k) dividends are compensation to employees, albeit they are in the form of dividends and are labeled dividends. Taxpayer offers a number of reasons in support of this conclusion.

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28. Of course, "ordinary" dividends do reduce accumulated earnings and profits, but that simply reflects the unsurprising fact that once a corporation has distributed earnings in the form of a dividend, those earnings are no longer available to be distributed in the future.

29. See I.R.C. § 316(a).

First, it is antithetical to the corporate income tax system to allow a deduction for any dividend paid because the system is premised on income being taxed both at the corporate level and the shareholder level. Acknowledging that an item's regular tax treatment cannot be dispositive for E & P purposes, Taxpayer nevertheless contends that the exceptional treatment of § 404(k) dividends for regular income tax purposes supports the assertion that the substance of these payments is compensation.

Second, the legislative history to § 404(k) suggests that these dividends are in the nature of compensation. For example, I.R.C. § 404(k)(5)(A) empowers the Treasury to disallow a deduction under § 404(k) when such a payment would constitute the avoidance of taxation. The legislative history to that provision states "[t]hus, for example, if amounts paid by an employer, and treated for tax purposes as 404(k) dividends, are the payment of unreasonable compensation, such payments would not qualify for treatment as section 404(k) dividends."[30] Reference to "unreasonable compensation," argues Taxpayer, would be unnecessary with regard to "ordinary" dividends, so such reference in the context of § 404(k) dividends suggests that these dividends are indeed an alternative form of compensation. In other words, if abusive payments in the form of § 404(k) dividends constitute unreasonable compensation, appropriate § 404(k) dividends must constitute reasonable compensation. It follows, insists Taxpayer, that any distribution in the nature of compensation cannot by definition be a true dividend. Likewise, an actual disbursement in the nature of compensation must reduce E & P.

Third, Taxpayer asserts that the employee-recipient's tax treatment of a 404(k) dividend favors its position. Specifically,

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30. S.REP. NO. 313, 99th Cong., 2d Sess. 1034 (1986).

although such amounts are reported as dividends, "the payment is to be treated, for any other purpose, as a plan distribution and not an investment income."[31]

Fourth, as mentioned by the Tax Court, generally accepted accounting principles (GAAP) customarily treat the payment of dividends to an ESOP as an expense for financial accounting purposes; "ordinary" dividends, of course, are not treated as an expense under GAAP. Inasmuch as accounting income, like E & P, attempts to measure economic income, Taxpayer reasons, GAAP's treatment of dividends paid to ESOPs provides support for allowing a deduction for purposes of calculating E & P.

Finally, Taxpayer argues that (1) the regulation in question undermines the tax-favored status that Congress has bestowed on ESOPs, and (2) the absence of an express statutory adjustment for § 404(k) dividends for AMT purposes counsels against finding one by way of tinkering with E & P and thus ACE.

In the absence of an express legislative regulation to the contrary, Taxpayer's arguments would be compelling and would be likely to carry the day. Once again, though, a highly deferential standard of review, rather than logical analysis, prevails. Treasury Regulation § 1.56(g)-1(d)(3)(iii)(E) is consistent with the fact that these payments are dividends in name and in form. No matter what other criticism we might level at the instant regulation, given our extremely restrictive standard of review and the fact that the Treasury's interpretation for purposes of AMT is congruent with the treatment of other

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31. Announcement 85-168, 1985-48 I.R.B. 40 (Dec. 2, 1985) (emphasis added).

dividends, we cannot go so far as to say that this regulation is arbitrary, capricious, or contrary to the statute. Even if we should harbor substantial doubts about whether Congress intended this result, and were to agree with Taxpayer that it is counter-intuitive in light of Congress's encouragement of the creation of ESOPs through the enactment of a comprehensive scheme of tax incentives—including deductibility of § 404(k) dividends—our review is shackled by the standard heretofore explained. We are therefore constrained to affirm the Tax Court's conclusion that Treasury Regulation § 1.56(g)-1(d)(3)(iii)(E) is valid. Any favorable change in the treatment of § 404(k) dividends for purposes of computing the ACE adjustment is a matter for Congress and not the courts.[32]

D. RETROACTIVE APPLICATION

As noted above, Taxpayer started planning for the adoption of an ESOP well before OBRA was enacted and actually entered into the ESOP transaction several months prior to the proposed regulation's issuance on May 3, 1990, albeit after the effective date of OBRA. Moreover, that regulation was not made permanent until March 15, 1991. Nevertheless, the Secretary of the Treasury did not act to make the effect of this regulation prospective only, choosing instead to make its retroactivity applicable to all taxable years ending after December 31, 1989, the month in which OBRA had been enacted. Taxpayer argues that this retroactive application was improper.

Section 7805(b) provides that the Secretary of the Treasury "may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied

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32. We cannot help but note in passing that Congress has not acted to change this matter in the five-plus years since the regulation was issued in permanent form.

without retroactive effect." Although we have noted that regulations generally will have retroactive effect, the failure to limit a regulation to prospective application only is nevertheless reviewable for an abuse of discretion.[33] Indeed, as other courts have exhorted in this context, "[t]he Internal Revenue Service does not have carte blanche."[34]

As we stated in Anderson, Clayton & Co, the following factors are relevant considerations when reviewing the Secretary's exercise of discretion to adopt retroactive regulations: (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result.[35]

This list of relevant considerations is neither exhaustive nor exclusive.[36] Indeed, as the list merely reflects a distillation of prior case law,[37] these factors are intended to serve as flexible

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33. Anderson, Clayton & Co. v. United States, 562 F.2d 972 (5th Cir.1977), cert. denied, 436 U.S. 944, 98 S.Ct. 2845, 56 L.Ed.2d 785 (1978).

34. International Business Machines Corp. v. United States, 170 Ct.Cl. 357, 343 F.2d 914, 920 (1965), cert. denied, 382 U.S. 1028, 86 S.Ct. 647, 15 L.Ed.2d 540 (1966).

35. Anderson, Clayton & Co., 562 F.2d at 981.

36. Id. at 981 n. 19.

37. Id. at 981.

guidance, not rigid requirements. Neither is the list conjunctive, as the Commissioner would urge; that is, a court need not conclude that all four considerations augur against retroactivity to require prospective effect only.

Of the four Anderson, Clayton factors, courts tend to emphasize the first one most heavily.[38] The Commissioner argues that, as no affirmative authority for deducting § 404(k) dividends in computing E & P existed prior to the issuance of the regulation in question, this factor provides no basis for complaining of the regulation's retroactivity. We find this approach to be convoluted: The more telling observation would be that, given the presumption of deductibility of § 404(k) dividends under the regular corporate income tax regime, no affirmative authority for disallowing such deductions for purposes of AMT existed prior to the issuance of the proposed regulation. Under the particular circumstances of this case, then, we reject the Commissioner's invitation simply to end the inquiry at this point.

True, prior to the issuance of the regulation in question, no authority had addressed the specific question whether § 404(k) dividends were deductible in computing E & P, one way or the other. By the same token, of course, no prior authority supported the proposition that § 404(k) dividends were not deductible. But this does not mean that settled law relevant to the issue did

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38. See, e.g., Helvering v. R.J. Reynolds Tobacco Co., 306 U.S. 110, 59 S.Ct. 423, 83 L.Ed. 536 (1939). Depending on the circumstances of a particular case, of course, other factors may be more important. See, e.g., International Business Machines Corporations v. United States, 170 Ct.Cl. 357, 343 F.2d 914 (1965), cert. denied, 382 U.S. 1028, 86 S.Ct. 647, 15 L.Ed.2d 540 (1966) (emphasizing the equality of treatment among similarly situated taxpayers).

not previously exist; indeed, it did. Prior to the issuance of the regulation in question, the law was settled that treatment of § 404(k) dividends was different from the treatment of "ordinary" dividends for virtually every purpose of the Internal Revenue Code. Similarly, the legal authorities discussed above, which point to the substance of § 404(k) dividends as being compensation, were settled law. Moreover, the fact that AMT had never before been imposed on § 404(k) dividends was settled law.[39] And, finally, the numerous tax incentives provided by Congress for the creation of ESOPs were settled law.

Our own review of the state of the tax law as it existed prior to the issuance of this regulation convinces us that Taxpayer and its expert advisors were entirely justified in relying on prior law for the conclusion that § 404(k) dividends are deductible in computing E & P; neither was there anything in the literature that would have given a corporate taxpayer any inkling, much less a reasonable basis, for predicting that § 404(k) dividends would be subjected to such a Draconian treatment as the one embodied in the subject regulation.[40] In this respect, the instant case is distinguishable from Anderson, Clayton & Co. in that Taxpayer can demonstrate much more than that the

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39. The ACE adjustment applies for taxable years beginning after December 31, 1989. Its predecessor was the book income adjustment, applicable to taxable years beginning in 1987, 1988, and 1989. See I.R.C. § 56(f) (repealed 1989). The book income adjustment essentially provided that to the extent that book income exceeded AMTI (as calculated to that point), an amount equal to 50 percent of this excess was added to AMTI. As GAAP customarily treats dividends paid to an ESOP as an expense, these dividends would not have been subjected to AMT in years prior to 1990.

40. Although of little, if any, weight, we note that the many negative comments received with regard to the proposed regulation comport with our analysis of the prior law and thus with the foreseeability—or lack thereof—of the position the Treasury embodied in the regulation.

law was merely "unsettled."[41] Furthermore, as illustrated by the facts of this particular case, the retroactive application of this regulation has already produced inordinately harsh results. Nevertheless, from the time that OBRA was adopted in December 1989, cautious corporate taxpayers could have and should have expected that significant changes in AMT were coming for corporations and that these changes would likely not be favorable to corporations. That observation, coupled with the general rule that tax regulations are presumably retroactive, at least to the effective date of the statute that they implement, keeps the instant taxpayer from pleading total unforeseeability, at least as a general proposition.

Despite these observations, we are constrained to conclude that the Secretary of the Treasury is not guilty of abuse of discretion in failing to limit the effect of regulation § 1.56(g)-1(d)(3)(iii)(E) to prospective only. The Supreme Court, in United States v. Carlton, noted that the test for the validity of retroactive effect of statutes and regulations affecting economic policy embodies a search for arbitrariness or irrationality, which turns on the presence or absence of a rational legislative purpose.[42] The Commissioner proffers two rational purposes for not limiting the subject regulation's effect to prospective only: The effective date of the regulation approximates the date of adoption of OBRA (and pre-dates Snap-Drape's adoption of its ESOP and the attendant bank borrowing); and the regulation is consistent with existing law. Although we have explicated our disagreement with the latter, we concede that the former is

41. Anderson, Clayton & Co. v. United States, 562 F.2d 972, 983-84 (5th Cir.1977), cert. denied, 436 U.S. 944, 98 S.Ct. 2845, 56 L.Ed.2d 785 (1978).

42. 512 U.S. 26, __, 114 S.Ct. 2018, 2022, 129 L.Ed.2d 22 (1994).

sufficient here to meet the rational purpose test. The legislation in question—OBRA—instructed the Secretary to adopt and implement regulations, and the regulation sub judice responds to that Congressional mandate. As such, Carlton's arbitrary-or-irrational test is met and we are powerless to abrogate retroactivity of the regulation. Even though, as was stated in International Business Machines Corporation, the Secretary of the Treasury does not have carte blanche to allow every regulation to remain retroactively effective, such retroactivity in tax regulations is presumed and the Secretary's decision not to limit the effect of this regulation to prospective effect only commands broad deference. We therefore affirm the Tax Court's holding, in favor of the Commissioner, that regulation § 1.56(g)-1(d)(3)(iii)(E) has application with respect to § 404(k) dividends for taxable years ending after December 31, 1989.

III

CONCLUSION

For the foregoing reasons, we hold that Treasury Regulation § 1.56(g)-1(d)(3)(iii)(E) is valid and that failing to make its effect prospective only did not constitute an abuse of discretion by the Secretary of the Treasury. The judgment of the Tax Court is therefore

AFFIRMED.

APPENDIX B — OPINION OF THE UNITED STATES TAX COURT FILED JULY 13, 1995

Snap-Drape, Inc. v. Commissioner, 105 T.C. 16

Docket No. 2174-93.

Filed July 13, 1995.

SNAP-DRAPE, INC.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

During taxable year 1990, P made contributions to its ESOP in the amount of $240,732 and claimed a deduction for the entire amount under sec. 404(a), I.R.C. P also paid to the ESOP a cash dividend with respect to its common stock in the amount of $1,440,000. The ESOP transferred the entire amount of the dividend to the Bank as payment of interest and principal under a note, executed for purposes of purchasing securities of P. On its 1990 Federal income tax return, P claimed a deduction with respect to the cash dividend paid to the ESOP in the amount of $1,440,000 under sec. 404(k), I.R.C. P did not include the sec. 404(k), I.R.C., deduction in the computation of its adjusted current earnings (ACE adjustment) for purposes of determining its alternative minimum tax (AMT), and, as a result, concluded that it was not liable for AMT. R determined that by failing to include the section 404(k), I.R.C., dividends in its ACE adjustment, P did not comply with section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., and thus failed to properly compute its AMT. Held: Sec. 1.56(g)-1(d)(3)(iii)(E), Income

Tax Regs., is valid. Held, further: R did not abuse her discretion by providing retroactive application of the regulation. Thus, sec. 404(k), I.R.C., dividends are not deductible in computing ACE for purposes of determining AMT.

John D. Copeland, for petitioner.

Robert Morrison and Michael Prindible, for respondent.

OPINION

WRIGHT, Judge: Respondent determined a deficiency in petitioner's Federal income tax for taxable year 1990 in the amount of $239,463.

After concessions by the parties, the issues for our consideration are as follows:

(1) Whether dividends paid to an employee stock ownership plan, deductible under section 404(k),[1] are deductible under section 56(g)(4)(C)(i) in computing the adjusted current earnings of a corporation for purposes of determining alternative minimum tax, and thus, whether section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., is valid. We hold that the section 404(k) dividends are not deductible under section 56(g)(4)(C)(i) and that the regulation is valid.

(2) Whether respondent abused her discretion by providing retroactive application of section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs. We hold that she did not.

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1. Unless otherwise indicated, all statutory references are to the Internal Revenue Code in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Appendix B

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein. At the time the petition was filed, petitioner's principal place of business was Carrollton, Texas.

Petitioner is a corporation organized and existing under the laws of Texas. Petitioner was formed during the 1970's and prior to February 22, 1990, was owned 100 percent by Raymond R. Belknap (Belknap) and Gerald E. Guebert (Guebert), equally. As of February 22, 1990, there were 1,240,000 shares of common stock issued and outstanding; Belknap and Guebert each owned 620,000 shares. Petitioner's principal business is the manufacturing and marketing of table skirting for buffet tables, banquet tables, conference tables, and the like. Petitioner is also in the textile business converting fabric into table skirting. Belknap and Guebert invented a clip which is used to attach the table skirting to the tables.

On February 1, 1990, petitioner established the Snap-Drape, Inc. Employee Stock Ownership Plan and Trust (the ESOP). Felton Norris, Darrin Garlish, and John Phillips were designated as the trustees. On January 22, 1991, respondent issued a favorable determination letter to the ESOP for qualification under sections 401(a) and 501.

Prior to February 1990, Belknap and Guebert decided to retire and sell their respective interests in petitioner. On February 22, 1990, the ESOP entered into an agreement with Belknap and Guebert. The agreement provided that the ESOP would purchase 1,000,000 shares of common stock in petitioner (approximately 80 percent of its common stock issued and Outstanding) from Belknap and Guebert. To facilitate the transaction the ESOP borrowed $5,000,000 from First City,

Texas-Dallas (the Bank), and executed a note payable to the Bank in the face amount of the same. The loan was guaranteed by petitioner. In addition, the note provided for mandatory prepayments of principal based upon a formula related to petitioner's available cash flow. Also on February 22, 1990, the ESOP distributed the proceeds of the loan by issuing a total of four checks, two each to both Belknap and Guebert, totaling $5,000,000 in exchange for 1,000,000 shares of petitioner's stock. Belknap and Guebert each received $2,500,000 in exchange for 500,000 shares of stock in petitioner.

During taxable year 1990, petitioner made contributions to the ESOP in the amount of $240,732 and claimed a deduction for the entire amount under section 404(a). Petitioner also paid to the ESOP a cash dividend with respect to its common stock in the amount of $1,440,000. The ESOP transferred the entire amount of the dividend to the Bank as payment of interest and principal under the note.

On its 1990 Federal income tax return, petitioner claimed a deduction with respect to the cash dividend paid to the ESOP in the amount of $1,440,000 under section 404(k) (section 404(k) deduction or section 404(k) dividend). Attached to petitioner's return, among other items, is Form 4626, Alternative Minimum Tax — Corporations. Petitioner did not include the section 404(k) deduction in the computation of its adjusted current earnings (ACE or ACE adjustment) for purposes of determining its alternative minimum tax (AMT), and as a result, concluded that it was not liable for AMT. Respondent determined that by failing to include the section 404(k) dividends in its ACE adjustment, petitioner did not properly compute its AMT and therefore is liable for AMT in the amount of $210,613.

Appendix B

Petitioner argues that section 1.56(g)-l(d)(3)(iii)(E), Income Tax Regs., is an improper interpretation of section 56(g)(4)(C)(i), and thus it is invalid. Alternatively, petitioner argues that if we find that the regulation is valid, respondent abused her discretion by providing retroactive application. Respondent argues otherwise. We agree with respondent.

EXPERT REPORTS

As a preliminary matter, petitioner offered two expert witness reports for consideration by the Court. The reports conclude that section 404(k) dividends are deductible for purposes of computing earnings and profits and are therefore deductible for purposes of computing the ACE adjustment. The reports also state that had respondent never issued section 1.56(g)-l(d)(3)(iii)(E), Income Tax Regs., the section 404(k) deduction would not be disallowed in computing the ACE adjustment. Each expert further opined that prior to the issuance of the regulation, it was not reasonably foreseeable that respondent would disallow a section 404(k) deduction for purposes of computing the ACE adjustment.

Prior to trial, respondent filed a Motion in Limine objecting to the testimony of the expert witness reports that petitioner offered into evidence. Respondent seeks the exclusion of the expert reports on the following grounds: (1) The reports address only questions of law and not fact; (2) the testimony offered by each witness constitutes only advocacy of the underlying legal question; and (3) the probative value of the reports is substantially outweighed by considerations of undue delay, waste of time, and needless presentation of cumulative evidence. Petitioner argues that even if we find that the reports contain improper conclusions of law as to whether section 1.56(g)-

l(d)(3)(iii)(E), Income Tax Regs., is valid, the reports should be accepted for purposes of considering whether respondent abused her discretion. Specifically, petitioner contends that the expert reports are helpful in determining whether it relied on settled law sufficient to preclude retroactive application of the regulation.

We agree with respondent that the reports contain improper conclusions as to issues of law and not fact, as well as statements of mere advocacy, which violate our holding in Laureys v. Commissioner, 92 T.C. 101 (1989). Although Laureys addressed expert testimony with respect to valuation issues, we believe that the principles stated therein are applicable to the instant case. Specifically, the experts in the instant case have become advocates for the position argued by petitioner. Id. at 129. After careful consideration of petitioner's expert reports, we find them to be of no assistance in making our findings of fact and deciding the issues in the instant case. Consequently, respondent's objections are sustained, and the reports will not be received in evidence.

VALIDITY OF REGULATION

Treasury regulations are not to be rejected unless they are unreasonable and plainly inconsistent with the revenue statutes. Rotenberry v. Commissioner, 847 F.2d 229 (5th Cir. 1988); Western Waste Indus. & Subs. v. Commissioner, 104 T.C. 472 (1995). The initial phase of an analysis considering the validity of a Treasury regulation generally requires the determination of whether the regulation in question is a legislative regulation or an interpretive regulation. Treasury regulations issued pursuant to a specific grant of congressional authority are entitled to an especially high degree of deference. Anderson, Clayton & Co. v. United States, 562 F.2d 972, 976 (5th Cir. 1977); Phillips

Appendix B

Petroleum v. Commissioner, 97 T.C. 30, 34 (1991). The regulation at issue in the instant case was issued pursuant to the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, sec. 7611(g)(3), 103 Stat. 2106, 2373. Section 7611(g)(3) of the Act provides:

> Regulations on Earnings and Profits Rules. — Not later than March 15, 1991, the Secretary of the Treasury or his delegate shall prescribe initial regulations providing guidance as to which items * * * of deduction are disallowed under section 56(g)(4)(C) * * *

We therefore conclude that section 1.56(g)-l(d)(3)(iii)(E), Income Tax Regs., is a legislative regulation, issued pursuant to a specific grant of authority and is entitled to an elevated degree of deference.

Where the Commissioner acts under specific authority, our primary inquiry is whether the interpretation or method is within the delegation of authority. Rowan Cos. v. United States, 452 U.S. 247, 253 (1981). The purpose for the enactment of the AMT regime is as follows:

> the minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are

> allowed to use them to avoid virtually all tax liability. The ability of * * * highly profitable corporations to pay little or no tax undermines respect for the entire tax system * * *. In addition, * * *, the committee believes that it is inherently unfair for * * * highly profitable corporations to pay little or no tax due to their ability to utilize various tax preferences.

In particular, both the perception and the reality of fairness have been harmed by instances in which major companies have paid no taxes in years when they reported substantial earnings, and may even have paid substantial dividends to shareholders. * * * [S. Rept. 99-313, at 518-519 (1986), 1986-3 C.B. (Vol. 3) 518-519.]

Based on the above rationale, Congress revamped the AMT provisions to include corporate taxpayers and promulgated a series of highly technical provisions designed to mirror the AMT imposed on individuals. See secs. 53 through 59.

Simply stated, AMT is equal to the excess of tentative minimum tax over the regular tax for the taxable year. Sec. 55(a). In the case of a corporation, the tentative minimum tax is 20 percent of the alternative minimum taxable income (AMTI) that exceeds the exemption amount,[2] reduced by AMT foreign tax credit. Sec.55(b)(1)(B). The term AMTI means the taxable income (for regular tax purposes) of a taxpayer determined with the adjustments provided in sections 56 and 58, and increased by the amount of the items of tax preference described in section 57. Sec. 55(b)(2).

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2. In the case of a corporation, the term "exemption amount" means $40,000. Sec. 55(d)(2).

Appendix B

With respect to corporate taxpayers, there is an adjustment for adjusted current earnings as provided under section 56(g). Sec. 56(c)(1). Section 56(g) provides:

> (1) In general. — The * * * [AMTI] of any corporation for any taxable year beginning after 1989 shall be increased by 75 percent of the excess (if any) of—
> (A) the * * * [ACE] of the corporation, over
> (B) the * * * [AMTI] (determined without regard to this subsection and the alternative tax net operating loss deduction).
> * * * * *
> (3) Adjusted current earnings. — * * * the term [ACE] means the * * * [AMTI] for the taxable year—
> (A) determined with the adjustments provided in paragraph (4), and
> (B) determined without regard to this subsection and the alternative tax net operating loss deduction.
> (4) Adjustments. — In determining * * * [ACE], the following adjustments shall apply:
> * * * * *
> (C) Disallowance of items not deductible in computing earnings and profits.—
> (i) In general. — A deduction shall not be allowed for any item if such item would not be deductible for any taxable year for purposes of computing EARNINGS AND PROFITS. [Emphasis added.]
> * * * * *
> (5) Other definitions. — For purposes of paragraph (4)—

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> (A) Earnings and profits. — The term "earnings and profits" means earnings and profits computed for purposes of subchapter C.

Congress authorized the Secretary to provide guidance as to which items of deduction are disallowed under section 56(g)(4)(C) for purposes of computing earnings and profits. The Omnibus Budget Reconciliation Act of 1989, Pub. L. 101-239, section 7611(g)(3), 103 Stat. 2106, 2373. Section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., was promulgated pursuant to this grant of authority and provides in pertinent part as follows:

> Section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs.—
> Partial list of items not deductible in computing earnings and profits.
> The following is a partial list of items that are not taken into accounting in computing earnings and profits and thus are not deductible in computing adjusted current earnings[ACE].
> * * * * *
> (iii) Dividends deductible under the following sections of the Code:
> * * * * *
> (E) Dividends paid to an employee stock ownership plan that are deductible under section 404(k).

The controversy in the instant case evolves from the treatment of section 404(k) dividends for purposes of computing

earnings and profits. Based on the foregoing regulation, section 404(k) dividends are not taken into account in computing earnings and profits, and therefore a corporate taxpayer may not deduct such dividends in computing its ACE adjustment. Petitioner argues that, contrary to section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., section 404(k) dividends are deductible in computing earnings and profits, and therefore the regulation is invalid. Respondent contends that section 404(k) dividends are essentially equivalent to regular dividends and are not deductible for purposes of computing earnings and profits or for purposes of computing ACE.

The primary purpose for determining the earnings and profits of a corporation is to ascertain the effect of a distribution of property by the corporation to its shareholders. Secs. 301(c), 316(a). A distribution is treated as a dividend to the extent of the corporation's earning and profits. Sec. 316(a). If a distribution is made in excess of current and accumulated earnings and profits, the excess is treated as a return of capital. Sec 301(c). Section 316(a) mandates that every distribution is first to be measured against the most recently accumulated earnings and profits; i.e., current year earnings and profits. When current year earnings and profits are exhausted, accumulated earnings and profits are then considered. Sec. 316(a). The parenthetical language in section 316(a)(2) specifically provides that earnings and profits for the current taxable year are to be measured without diminution by reason of distributions made during the current taxable year.

The Internal Revenue Code does not specifically define the phrase "earnings and profits". See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 8.03 at 8-16 (6th ed. 1994). A corporation's earnings and profits are

generally computed by making adjustments to its taxable income. See sec. 1.312-6(a) and (b), Income Tax Regs.; see also sec. 312. Petitioner argues that section 404(k) dividends are deductible in computing taxable income and there is no code provision which requires them to be added back for purposes of computing earnings and profits. Therefore, petitioner concludes that the section 404(k) dividends are deductible in computing earnings and profits.

Petitioner's argument may be summarized as follows: Taxable income, as the starting point for determining earnings and profits, is adjusted for: (1) Certain items excluded from taxable income that must be included in computing earnings and profits, e.g., interest on State and municipal obligations; (2) items deducted in computing taxable income that may not be deducted in computing earnings and profits, e.g., the dividends received deduction; (3) certain timing differences, e.g., depreciation; and (4) items not deducted in computing taxable income that may be deducted in computing earnings and profits, e.g., Federal income taxes. According to petitioner, section 404(k) dividends do not fall into any of these categories. Petitioner reasons that category two above, items deductible for computing taxable income which may not be deducted in computing earnings and profits, includes artificially created deductions that do not represent actual expenses or expenditures. Petitioner concludes that section 404(k) dividends are not an artificial deduction because they represent an actual outlay of funds. We do not agree with this proposition. A dividend deductible under section 404(k) is, in fact, an artificial deduction because generally, a corporation may not claim a deduction for a cash distribution with respect to its stock. Sec. 311(a).

Petitioner reaches its conclusion, in part, by equating section

404(k) dividends to compensation. Petitioner argues that section 404(k) dividends are akin to compensation because the provision exists under the deferred compensation provisions of the Code and the benefit is ultimately received by participating employees. We are not persuaded by this analogy. We find no authority for treating section 404(k) dividends in a manner different from regular dividends for purposes of computing earnings and profits.

Petitioner further relies on the treatment of ESOP dividends for accounting purposes as espoused by the American Institute of Certified Public Accountants (AICPA). We are mindful that the Code does not contain a comprehensive definition of earnings and profits. See Williams, Earnings and Profits, 762 Tax Mgmt. (BNA) A-38 (1992). Nevertheless, we reject petitioner's contention that ESOP dividends reduce earnings and profits. Earnings and profits in the tax sense, although the term does not correspond exactly to taxable income, does not necessarily follow corporate tax accounting concepts, either. Commissioner v. Wheeler, 324 U.S. 542, 546 (1945); DiLeo v. Commissioner, 96 T.C. 858, 888 (1991), affd. 959 F.2d 16 (2d Cir. 1992).

We find that the regulation is consistent with the revenue statutes and with the intent of Congress. It is well established that deductions are a matter of legislative grace. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); Estate of Manscill v. Commissioner, 98 T.C. 413, 418 (1992), supplemented by T.C. Memo. 1992-571. With respect to dividends paid to an ESOP, Congress intended to provide an incentive for corporations to establish an ESOP. Consequently, Congress exercised its legislative powers and provided a deduction for corporations when its ESOP uses cash dividends

(1) to service debt incurred to acquire employer securities, or (2) when the ESOP distributes the cash dividend to the plan beneficiaries within the requisite 90-day period. Sec. 404(k). Nevertheless, Congress also sought to ensure that each corporate taxpayer was in fact paying a fair share of tax. This aim ultimately inspired the creation of the AMT regime. S. Rept. 99-313 (1986), 1986-3 C.B. (Vol. 3) 518-519.

It is not uncommon for Congress to have conflicting goals. Martin v. Sullivan, 932 F.2d 1273, 1278 (9th Cir. 1991); Combined Communications v. U.S. Postal Service, 891 F.2d 1221, 1223 (6th Cir. 1989); Tennessee v. Herrington, 806 F.2d 642 (6th Cir. 1986); Tierney v. Schweiker, 718 F.2d 449, 454 (D.C. Cir. 1983). Petitioner's position would further only the first goal, i.e., to facilitate the establishment of ESOPs, and defeat the second goal, i.e., to ensure that each corporate taxpayer pays a fair share of tax. Respondent's position furthers both goals. Petitioner contends that the regulation nullifies the benefit provided by section 404(k), but this is simply not so. Although the benefit is lessened in the current year, it is not totally eliminated.[3] Petitioner may be entitled to claim a credit against regular tax in a subsequent year for the amount of AMT paid in the current year. Sec. 53. Further, it is well established that considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer, and the principle of deference to administrative interpretations:

> has been consistently followed * * * whenever decision as to the meaning or reach of a statute has involved reconciling

3. See Illinois Cereal Mills, Inc. v. United States, 74 AFTR2d 6105, 94-2 USTC par. 50458 (C.D. Ill. 1994).

> conflicting policies, and a full understanding of the force of the statutory policy in the given situation has depended upon more than ordinary knowledge respecting the matters subjected to agency regulations.

If this choice represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned. [Chevron U.S.A. v. Natural Res. Def. Council, 467 U.S. 837, 844-845 (1984); citations omitted.]

The legislative history reveals that Congress intended the result reached by the regulation at issue. The Conference Report accompanying the Tax Reform Act of 1986 provides:

> Adjusted current earnings measures pre-tax income without diminution by reason of any distribution made during the taxable year. * * *. Moreover, no deduction is allowed with respect to a dividend paid. [H. Conf. Rept. 99-841 (1986), 1986-3 C.B. (Vol. 4) 276.]

Accordingly, we find that the Commissioner acted within her delegation of authority, and that section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., harmonizes with the revenue statutes and is therefore valid.

RETROACTIVE APPLICATION

As an alternative to its principal argument, petitioner

contends that respondent abused her discretion by providing retroactive application of section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs. Section 1.56(g)-1(d)(3)(iii)(E), Proposed Income Tax Regs., 56 Fed. Reg. 11080, was finalized on March 15, 1991, and it applies to all years ending after December 31, 1989. T.D. 8340, 1991-1 C.B. 4,6.

In Anderson, Clayton & Co. v. United States, 562 F.2d 972 (1977), the Court of Appeals for the Fifth Circuit[4] listed four factors necessary to find an abuse of respondent's discretion with regard to the retroactive application of a regulation. A combination of all four factors may cause a court to limit a regulation to prospective application only. The factors listed in Anderson are:

> (1) Whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law;
> (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent Code provisions;
> (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and
> (4) whether according retroactive effect would produce an inordinately harsh result.

[562 F.2d at 981; fn. ref. omitted.]

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4. In the instant case, appeal lies with the Court of Appeals for the Fifth Circuit.

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Petitioner argues that it satisfies the first factor. However, petitioner has not shown that it justifiably relied on settled law that was altered by the regulation. We do not believe that the regulation at issue altered settled law. Almost since the inception of the income tax, earnings and profits have been the device used to measure the taxability of a distribution by a corporation to its shareholders. Revenue Act of 1916, ch. 463, tit. I, sec. 2(a), 39 Stat. 756, 757. As previously discussed, the earnings and profits computation is performed prior to the consideration of the distribution itself. Sec. 316(a)(2). Earnings and profits for the current year are measured without diminution by reason of dividends paid during that year. The regulation confirms this result; it does not alter it.

Petitioner also argues that it satisfies the fourth condition, i.e.; that the regulation imposes a harsh result because the ESOP transaction was structured in anticipation that the company would not incur a significant Federal tax liability. Specifically, the note provided for mandatory prepayments of principal based upon a formula related to petitioner's available cash flow. According to petitioner, if it is required to pay AMT, its cash flow will be reduced below anticipated levels resulting in: (1) Less working capital available for expansion and growth; (2) a longer period of repayment period on the note; (3) greater interest incurred; (4) a reduction in the value of the corporation, and thus reduced equity of the shareholders; (5) a reduced value of the account of each ESOP participant; and (6) a burden on certain employees scheduled to retire in the near future.

We are not convinced that any of the above consequences will occur solely as a direct result of the regulation in question. The regulation was issued in proposed form on May 3, 1990. Sec. 1.56(g)-l(d)(3)(iii)(E), Proposed Income Tax Regs., 55 Fed.

Reg. 18636 (May 3, 1990). Petitioner maintains that the transaction would not have been feasible had it been foreseen that section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., would have come into effect. Nevertheless, the evidence reveals that the section 404(k) dividends were paid subsequent to the issuance of the proposed regulation; thus, petitioner could have arranged its finances in a manner that would have minimized the effect of the regulation. See Wendland v. Commissioner, 79 T.C. 355, 382 n. 15 (1982), affd. sub nom. Redhouse v. Commissioner, 738 F.2d 1249 (9th Cir. 1984). Further, we are unpersuaded that the alleged above consequences satisfy the fourth condition as envisioned by the Court of Appeals for the Fifth Circuit under Anderson, Clayton & Co.[5] We have recognized that cases in which retroactive effect of a regulation amounts to an abuse of discretion are rare and usually occur where the detriment is very severe. Beneficial Life Ins. Co. v. Commissioner, 79 T.C. 627, 642 (1982); see also CWT Farms, Inc. v. Commissioner, 79 T.C. 1054, 1068-1069 (1982), affd. 755 F.2d 790 (11th Cir. 1985) (retroactive application of a regulation was sustained where the taxpayer unjustifiably relied on a handbook published by respondent for guidance).

We have considered petitioner's remaining arguments and find them to be without merit. Accordingly, we find that

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5. In Lansons, Inc. v. Commissioner, 622 F.2d 774 (5th Cir. 1980), affg. 69 T.C. 773 (1978), the Court of Appeals for the Fifth Circuit held that the Commissioner committed an abuse of discretion by retroactively revoking an earlier individualized favorable determination letter approving "qualified trust" status with respect to the taxpayer's profit sharing plan. The Court ruled that there had been no change in the material facts affecting the plan, and the taxpayer had relied on the previous determination letter stating that the trust was qualified. As a result of the Commissioner's action, the taxpayer, as well as its employees, would have suffered adverse tax consequences.

respondent did not abuse her discretion in applying the regulation retroactively.

CONCLUSION

In conclusion, we hold that respondent acted within the delegation of authority and that section 1.56(g)-1(d)(3)(iii)(E), Income Tax Regs., is consistent with the revenue statutes. We further hold that respondent did not abuse her discretion by providing retroactive application of the regulation. Thus, section 404(k) dividends are not deductible in computing ACE for purposes of determining AMT.

To reflect the foregoing,

Decision will be entered
under Rule 155.